Q2 2021 | Putnam Municipal Bond Funds Q&A

Municipals rally as investors weigh inflation concerns

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Municipal technicals remained strong, and fundamentals improved on the heels of stronger economic growth and sizable fiscal stimulus.

With valuations at relatively rich levels versus history, we would view any rate volatility or a market sell-off as a buying opportunity.

With the easing of mobility restrictions and the roll out of the American Rescue Plan, we believe that U.S. economic growth will remain strong in the second half of 2021.

How did municipal bonds perform during the second quarter of 2021?

The asset class delivered positive performance amid falling interest rates, strong growth, and solid supply/demand technicals.

After a sharp rise in the first quarter of 2021, rates fell during the second quarter. The yield on the benchmark 10-year U.S. Treasury note declined from 1.74% on March 31, 2021, to 1.45% on June 30, 2021. At the same time, vaccination progress led to a strong reopening in the United States, which gave way to inflation concerns and speculation that the Federal Reserve might begin scaling back its support for the U.S. economy. In May 2021, the Fed signaled it was considering tapering its $120 billion in monthly asset purchases. In June 2021, however, the Fed assumed a more hawkish tone. In their commentary, Fed officials projected two rate increases in 2023 if recent inflation persisted, which was sooner than expected. Although the Fed would continue its asset purchases near term, it indicated it was still considering tapering its asset purchases at some point.

Despite these concerns, municipal bonds gained ground due to several tailwinds. Credit fundamentals continued to improve due to a strong economic backdrop and the U.S. government's unprecedented stimulus. The most recent aid package, the American Rescue Plan [ARP], which became law in March 2021, provided a windfall of $350 billion in direct aid to states and local governments. This support, coupled with the fact that state budgets have generally outperformed conservative forecasts, has raised the outlook for some of the largest issuers in the municipal bond market. Transit agencies, colleges and universities, and school districts are among the municipal sectors that were targeted for substantial aid in the ARP. Furthermore, local municipalities have benefited from a strong housing market and higher revenue raised by local property taxes.

Supply/demand technicals also factored into performance results. Total municipal issuance was $222 billion in the first half of 2021, which represented a 6% increase year over year through June 30, 2021. Taxable municipal issuance fell 4% year over year. [Source: The Bond Buyer.] This issuance was met with solid demand. Municipal bond fund inflows, a measure of investor demand, totaled $27 billion for the second quarter, with year-to-date inflows totaling nearly $60 billion through June 30, 2021. [Source: Lipper, a Refinitiv company.] This already positions 2021 as the third-highest municipal fund inflow year on record. We believe a potential increase in the corporate income tax rate is helping to spur additional municipal bond buying by taxable institutional investors, such as U.S. banks and insurance companies. Similarly, an increase in personal tax rates could stimulate further demand by individual investors.

For the three months ended June 30, 2021, the Bloomberg Barclays Municipal Bond Index returned 1.42%, outperforming the 0.00% return for U.S. Treasuries. Revenue bonds outperformed general obligation bonds. On the credit spectrum, higher-yielding, lower-rated municipal bonds outpaced higher-rated municipal bonds for the quarter.

How were the funds positioned in this environment?

At quarter-end, the funds held an overweight exposure to investment-grade bonds rated A and BBB relative to the benchmark. The funds also held a slightly underweight exposure to lower-rated, high-yield bonds relative to their respective Lipper peer groups. From a sector- or industry-positioning perspective, we continued to favor higher education, retirement community, land development, and multifamily housing bonds relative to the funds' Lipper peer groups. Duration positioning, a measure of the funds' interest-rate sensitivity, was generally neutral relative to the level of their respective Lipper peer groups at period-end. Our yield-curve strategy was defined by an overweight position in bonds with maturities of 10 to 20 years relative to the Lipper peer groups at period-end. As part of this strategy, the funds generally held an underweight exposure to long maturity holdings compared with the benchmark.

The funds held an overweight exposure to revenue bonds compared with their Lipper peer groups. The funds' exposure to state and local governments was limited to those with, in our view, diverse tax bases and the ability to enact broad revenue enhancements or expense cuts. As part of our strategy for state debt, the national municipal bond funds held an overweight exposure to Illinois relative to their Lipper peer groups. We believe Illinois's financial profile continues to stabilize, and its flexibility and credit fundamentals have improved since the onset of the Covid-19 pandemic in the United States.

We remain cautious on Puerto Rico due to what we believe are its seemingly fragile economy, weak demographic trends, poor-quality infrastructure, volatile political environment, and history of fiscal mismanagement. As such, the funds remained underweight in their exposure to uninsured Puerto Rico municipal debt compared with their Lipper peer groups. We continue to monitor the Commonwealth's ongoing restructuring efforts for potential opportunities.

What is your outlook for the second half of 2021?

If an infrastructure bill is passed, it would likely be a positive development for many municipal borrowers, particularly state and local governments, transit agencies, airports, and other entities that typically finance transportation infrastructure. Water/sewer and electric utilities are also likely to benefit from a broad infrastructure bill. In our view, federal grants for these projects would reduce the need for municipal borrowers to issue debt to cover these essential services. This could increase fiscal flexibility for these borrowers while avoiding higher tax burdens.

In addition, we believe that, with the easing of mobility restrictions and the ARP, U.S. economic growth will remain strong in the second half of 2021. At the same time, we believe the Fed remains committed to its twin goals of maximum employment and 2% sustained inflation. With these and other factors at play, we believe the lower tiers of the investment-grade market, particularly BBB-rated securities and some parts of the high-yield market, represent some of the best income and return opportunities. Despite pandemic challenges, year-to-date defaults remain low and within long-term ranges. Even with Covid-19 challenges in 2020, the default rate represented less than 0.25% of the overall municipal bond market, according to Municipal Market Analytics.

Municipal bonds were one of the best performing fixed-income asset classes during the first half of 2021. Given the rally, we are more cautious on valuations as the third quarter begins. Prior to the onset of the pandemic, credit spreads were at the tightest levels since 2008, reflecting improving creditworthiness. [Credit spreads reflect the difference in yield between higher- and lower-rated municipal bonds.] Spreads widened significantly during the 2020 sell-off, particularly for the lower-quality cohort, but have since tightened significantly. At this time, we believe spreads have fully recovered from the Covid-19-induced sell-off. This produced a municipal and U.S. Treasury yield relationship, referred to as the Municipal/Treasury [M/T] ratio, sitting at levels that we view as its richest point in over 20 years. [The M/T ratio measures the yield on AAA-rated municipal bonds relative to the yield on U.S. Treasuries of similar maturities and is one of our valuation tools in determining the relative richness or cheapness of municipals relative to U.S. Treasuries.]

The current uncertainties surrounding the path of inflation and the course of the pandemic could lead to increased interest-rate volatility. With valuations at relatively rich levels versus history, we would view any rate volatility or a market sell-off as a buying opportunity, especially in the lower-investment-grade and high-yield sectors of the municipal bond market.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 6/30/21

	Class Y shares Inception 1/2/08	**Bloomberg Barclays Municipal Bond Index**
Last quarter	2.17%	1.42%
1 year	6.59	4.17
3 years	5.54	5.10
5 years	3.66	3.25
10 years	4.68	4.28
Life of fund	6.31	—

Total expense ratio: 0.58%

Source: Bloomberg Index Services Limited.

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 6/30/21

	Class Y shares Inception 1/2/08	**Bloomberg Barclays Municipal Bond Index**
Last quarter	3.41%	1.42%
1 year	11.88	4.17
3 years	6.54	5.10
5 years	4.73	3.25
10 years	6.17	4.28
Life of fund	5.88	6.29

Total expense ratio: 0.63%

Source: Bloomberg Index Services Limited.

Returns for periods of less than one year are not annualized.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. Class Y shares before their inception are derived from historical performance (Tax Exempt Income Fund, class A inception 12/31/76; and Tax-Free High Yield Fund, class B inception 9/9/85), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, these funds may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The Bloomberg Barclays Municipal Bond Index is an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds. It is not possible to invest directly in an index.

The ICE BofA U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S.-dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot invest directly in an index.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of June 30, 2021, are subject to change with market conditions, and are not meant as investment advice.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

Consider these risks before investing: Capital gains, if any, are taxed at the federal and, in most cases, state levels. For some investors, investment income may be subject to the federal alternative minimum tax. Income from federally tax-exempt funds may be subject to state and local taxes. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds. Unlike bonds, funds that invest in bonds have fees and expenses. The fund may invest significantly in particular segments of the tax-exempt debt market, making it more vulnerable to fluctuations in the values of the securities it holds than a more broadly invested fund. Interest the fund receives might be taxable. The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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